Conference Call of the Federal Open Market Committee on
August 10, 2007

A conference call of the Federal Open Market Committee was held on Friday, August 10, 2007, at 8:45 a.m. Those present were the following:

Mr. Bernanke, Chairman
Mr. Geithner, Vice Chairman
Mr. Hoenig
Mr. Kohn
Mr. Kroszner
Mr. Mishkin
Mr. Moskow
Mr. Poole
Mr. Rosengren
Mr. Warsh

Mr. Fisher, Ms. Pianalto, and Mr. Plosser, Alternate Members of the Federal Open Market Committee

Messrs. Lacker and Lockhart, and Ms. Yellen, Presidents of the Federal Reserve Banks of Richmond, Atlanta, and San Francisco, respectively

Mr. Madigan, Secretary and Economist
Ms. Danker, Deputy Secretary
Ms. Smith, Assistant Secretary
Mr. Skidmore, Assistant Secretary
Mr. Alvarez, General Counsel
Ms. Johnson, Economist

Messrs. Connors, Evans, Fuhrer, Rasche, Sellon, Slifman, and Wilcox, Associate Economists

Mr. Dudley, Manager, System Open Market Account

Mr. Parkinson, Deputy Director, Division of Research and Statistics, Board of Governors

Messrs. Clouse and English, Senior Associate Directors, Divisions of Monetary Affairs, Board of Governors

Mr. Luecke, Senior Financial Analyst, Division of Monetary Affairs, Board of Governors

Ms. Mester, Messrs. Sniderman and Weinberg, Senior Vice Presidents, Federal Reserve Banks of Philadelphia, Cleveland, and Richmond, respectively

Mr. Koenig, Vice President, Federal Reserve Bank of Dallas

Transcript of the Federal Open Market Committee Conference Call of August 10, 2007

CHAIRMAN BERNANKE. Good morning, everybody. As you know, financial markets have been fragile. They appeared to continue to be quite fragile overnight. There are difficulties with commercial paper funding and other short-term funding and a lot of concerns about counterparty risk. This morning the Desk, responding to a situation with the federal funds rate trading well above the target, did a large early operation and announced that to the markets. They are prepared to come back throughout the day to continue providing reserves as needed to keep the federal funds rate at our target. We are also proposing at 9:15 to release a statement essentially saying that. I will now read you the statement:

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> The Federal Reserve will provide reserves as necessary through open market operations to promote trading in the federal funds market at rates close to the Federal Open Market Committee's target rate of 5¼ percent. In current circumstances, depository institutions may experience unusual funding needs because of dislocations in money and credit markets. As always, the discount window is available as a source of funding."

So we're just saying that we are here, we are going to try to maintain the fed funds rate at 5¼ percent, we will provide adequate reserves, and we're going to try to work against any remaining stigma associated with borrowing at the discount window.

What I'd like to do is have Bill Dudley and Brian Madigan brief you about the state of the markets and give you a chance to ask questions. No action is being contemplated at this meeting.

This is informational, but we wanted to keep you apprised of the situation and of our proposal to issue this statement. Bill, are you available?

MR. DUDLEY. I am. Foreign central banks around the world added reserves aggressively overnight. The Bank of Japan, for example, added ¥1 trillion, about $8.4 billion. Their Euroyen rates were trading a little above the target before their addition and below the target afterward. So the action was effective. The ECB today did a variable-rate tender, a little different from what they did yesterday. Yesterday they took all comers at 4 percent. In today's variable-rate tender, they did not accept all the bids. They accepted €61 billion in bids. That's down from the €94.8 billion they accepted yesterday. The average rate was 4.08 percent compared with their 4 percent target.

Coming into New York time this morning, the federal funds rate was under upward pressure—6 percent or so for foreign names and 5.75 percent for domestics. We did a $19 billion three-day RP (repurchase) this morning, a single tranche RP with a 5.15 percent effective rate. There were $31 billion in propositions, and we accepted $19 billion. After that action, the funds rate has come off a bit. Foreign names are now 5.5 to 5.63. Domestics are 5.25 to 5.5. We expect the funds rate to come off through the day. But if it doesn't, we're prepared to engage in additional transactions later in the day. Yesterday we were a bit surprised that, despite a $24 billion add through a term RP and an overnight, the effective funds rate was 5.41 percent—so, firmer than the target—although it did go out on the softer side at the end of the day at 4.75 to 5 percent.

In terms of the markets, there are two broad sets of issues. One, there are concerns about funding issues for two large U.S. financial entities. Washington Mutual and Countrywide have both made statements in their 10(q) filings that unnerved the market a little, Washington Mutual saying that they're having some trouble in terms of liquidity and Countrywide saying that there are unprecedented disruptions in the credit market. Both of those companies have been singled out a bit this morning. In addition, there's a tremendous amount of focus on the commercial paper market. The European commercial paper market is not doing well at all, and that's really one reason that you're seeing the European banks scramble for funding.

I talked to a dealer this morning in the U.S. commercial paper market. I guess the way I would characterize the situation is that the U.S. commercial paper market is continuing to function but at a very tough level of functionality. People are shortening up. They are starting to take names off their lists of programs they'll invest with. The asset-backed commercial paper (ABCP) market is the area of greatest stress. The traditional programs, such as funding credit-card receivables, are still doing okay, but the extendable ABCP programs are under pressure. Also, apparently some investment bank programs are seeing some stress for their own names. There's a lot of shortening of maturity. A lot of people are doing things that are either just overnight or out to a week. So you're seeing that the funding in the U.S. commercial paper market is shortening, and therefore every day more and more commercial paper that has to be

rolled over is coming due. But I would say that, at this point, the U.S. commercial paper market is still functioning, and that's where we are right now.

CHAIRMAN BERNANKE. Brian, would you like to add anything?

MR. MADIGAN. No, that was complete, Mr. Chairman.

CHAIRMAN BERNANKE. Are there any questions for Brian or Bill? President Lacker.

MR. LACKER. Bill, I have a couple of things. There are asset-backed commercial paper programs that are backed by mortgage-backed securities. How much of those are showing up in our mortgage-backed tranches in recent RPs, in recent interventions like yesterday's? I guess you don't find out until later in the day how much of that shows up in today's intervention. Another question I have would be how late in the day you feel that you can do another RP operation.

MR. DUDLEY. What was the second question, Jeff?

MR. LACKER. The other one is, How late in the day do you think you can do an RP operation? Then a third question I have has to do with the RP market in general. I've heard about asset-backed paper going into RP programs instead of outrights, and I'm wondering whether that's affecting trading in the RP market and whether there are RP spreads for different collateral. What are you hearing about that?

MR. DUDLEY. As far as what we get in terms of propositions today, we're assuming that it will be mostly mortgage-related RPs since we did a single tranche and did not distinguish among different types of collateral. But I don't have the answer to that question in terms of what the composition of today's $19 billion RP was; we are presuming that it will be mostly mortgage related. As far as how late in the day, we can go fairly late. Obviously the effectiveness diminishes considerably if we go later in the day, and I think it is more symbolic. Our feeling is that the $19 billion we added today should be more than enough, and so we would expect the fed funds rate to come off. The reason the Desk statement said that we would come back if necessary was that we

wanted to reassure people that this wasn't their only chance to get reserves if things were to deteriorate as we go through the day. So I think we'll take a look at where things are at midmorning. If the fed funds rate is still trading firm to the 5¼ target, I think we would come in fairly early—midmorning.

CHAIRMAN BERNANKE. Other questions. President Hoenig.

MR. HOENIG. Yes. I don't know if Tim, Bill, or maybe Brian can answer this, but I'm interested in whether we're seeing or having conversations with any of the banks in terms of lines of credit being pulled or any kinds of pressures they might be sensing that would have implications for the discount window as side effects.

MR. DUDLEY. This is Bill Dudley. I'm not aware of any news on that front. I think Washington Mutual will be the one on which you would be most focused, given what they said overnight in terms of their filing. Obviously, they are focused on mortgage-related products, so I think they would probably be having the most difficulty today. I'm not aware of any other places with problems.

VICE CHAIRMAN GEITHNER. Tom, this is Tim. We have no indication that the major, more diversified institutions are facing any funding pressure. In fact, some of them report what we classically see in a context like this, which is that money is flowing to them. That, of course, could change quickly. But apart from those that are more narrowly in the mortgage market that can't basically sell any non-agency products, I don't think we're seeing any sense of funding pressure.

CHAIRMAN BERNANKE. Governor Mishkin.

MR. MISHKIN. Yes, I'd just like to understand a bit more about what's going on in terms of Europe. My understanding is that yesterday, when the European Central Bank injected all that

liquidity, a lot of it was done through borrowing from their standing facility. Do we have an idea of what exactly the banks are using those funds for?

MR. DUDLEY. Our understanding, Governor Mishkin, is that they're using them essentially to fund some of the commercial paper in Europe that's running off. Also, I think some of the funds are just extra liquidity, precautionary balances for reserves. We received a comment overnight that suggested that there was a potentially fairly significant misallocation of reserves within Europe as people were hoarding their liquidity. So some of the funds are probably being used to replace commercial paper, but some of them are probably just being held as precautionary balances.

MR. MISHKIN. So is it spending directly? Are the banks buying commercial paper, or are they lending directly to the people who can't roll over their commercial paper?

MR. DUDLEY. I don't know the answer to that.

CHAIRMAN BERNANKE. President Poole.

MR. POOLE. Is there a downside to providing funds more generously than we are now, deliberately pushing the fed funds rate decidedly below 5¼ just to try to smooth everything over here?

MR. DUDLEY. Well, if we are successful, we should expect that the fed funds rate could soften significantly, but there's no way that we can stabilize it at 5¼, if that's your question. One consequence of being aggressive and adding reserves is that, if we're successful, late in the day the funds rate could be trading at 1 or 2 percent. That's a possibility.

MR. POOLE. Let me restate the question. If it appears this morning after trading for an hour or two that we're still not decisively below 5¼, it would seem to me that we ought to consider

putting in more because we have weekend strains and so forth—so make a fairly decisive move at this point rather than a move that the market might consider as just doing barely enough.

MR. DUDLEY. Well, that's what we're prepared to do—to do more.

CHAIRMAN BERNANKE. I think it's our intention to be aggressive and to go below 5¼ percent if at all needed. However, we have not changed the target, and we don't want to convey the sense that we've changed the target, but we will be aggressive. President Fisher.

MR. FISHER. Mr. Chairman, do we know if our European colleagues have insisted on any discipline in return for their actions? That's also my question with regard to our own procedures here. I like the particular reference to the discount window. What concerns me is that we're issuing a statement. I like the statement, but what are we getting in return? In other words, how does this action help us rein in what has been reckless and irresponsible behavior by creditors? We're putting our finger in the dike here, but what are we getting in return? I'd also like to know what our thoughts are about that as we proceed down this path: (a) Have we heard from your counterparts, Mr. Chairman, as to the kind of discussions they're having with their creditors, and (b) do we expect that, say, New York, San Francisco, and Richmond are going to sit down with some of these bankers, if necessary, to provide a little moral suasion, or is that just not in the picture right now?

CHAIRMAN BERNANKE. President Geithner, did you want to intervene?

VICE CHAIRMAN GEITHNER. Richard, we've been talking to these people several times a day, and we'll do so again today. But I guess I don't feel that at this point we can do anything appropriate that is more powerful than this statement, and I'm not sure that it makes any sense for us to try to persuade these people to lend to a bunch of institutions that they're not comfortable lending to now. I don't really feel as though there's an effective way for us to condition this. You know, we have no indication that people are going to come to the window on

any significant scale. If we think that there's a liquidity problem that could be effectively relaxed by encouraging people to come to the window and that would make them more likely to help meet that constraint, then we can get to that point. But at this stage I don't think it's helpful or necessary for us to try to induce these people to on-lend what they may come to us later in the day for at the window. We may get to that point, but I don't think that makes sense now.

MR. FISHER. You are well aware, based on our conversation at the FOMC meeting, what the risks that I'm worried about here are. At the same time, I think we're doing the correct thing. I just want to keep bearing in mind the risk that we don't send any signal that we're just going to be, and obviously we wouldn't be, indiscriminate. But there has to be something in return for our providing liquidity in the markets if we continue to do so. I wanted to make that point.

VICE CHAIRMAN GEITHNER. I don't agree with that. I don't think that's the way to think about it. This is a general signal that we're prepared to relax or to provide liquidity to help make sure markets come back in some more orderly functioning. You can't condition that statement without undermining its basic power in some sense.

MR. FISHER. No, don't amend the statement. I just want to have that mindset. That's my point, and I won't say anything more.

CHAIRMAN BERNANKE. President Fisher, our goal is to provide liquidity not to support asset prices per se in any way. My understanding of the market's problem is that price discovery has been inhibited by the illiquidity of the subprime-related assets that are not trading, and nobody knows what they're worth, and so there's a general freeze-up. The market is not operating in a normal way. The idea of providing liquidity is essentially to give the market some ability to do the appropriate repricing it needs to do and to begin to operate more normally. So it's a question of market functioning, not a question of bailing anybody out. That's really where we are right now.

MR. FISHER. I've got it, Mr. Chairman. Thank you.

CHAIRMAN BERNANKE. President Lacker.

MR. LACKER. Just in response to you, Richard, I agree with Tim that the last thing we want to do is to be sending a message behind the scenes as we did in '87, encouraging anybody to lend to anybody they wouldn't otherwise be interested in lending to under their current operating risk-management standards. What I like about the statement that the Chairman read to us is the focus on keeping the federal funds rate near its target. I think that's what we should remain focused on. Credit spreads are beyond our ability to peg or influence, and I don't think we should go down the road of trying to do so. I agree with President Geithner that the statement takes its power from that. It's important for us in our deliberations to remain clinical about this and very specific in our diagnosis of symptoms and what's going on. I think markets are working fine. The quantities just happen to be zero right now in some of them, [laughter] and things are going to hell in a handbasket.

MR. FISHER. Thank you, President Lacker.

CHAIRMAN BERNANKE. President Plosser.

MR. PLOSSER. Thank you, Mr. Chairman. I have a question. Bill suggested that, at some point—perhaps during the day, maybe tomorrow, or sometime—as we continue to introduce liquidity, the funds rate actually may fall quite precipitously to 1 or 2 percent for a short period. I'm fully supportive of the statement, and like President Lacker, I like the fact that the stress in the statement is that our goal is to keep the fed funds rate near its target and that we haven't changed the target. But I do have a question about the unwinding of this. That is, what are the criteria for when we stop introducing liquidity? How do we decide when to do that, and is there any thought as to how we unwind the liquidity that we may have injected during the process? What is the idea about the process of how that unwinding might occur? Thank you.

CHAIRMAN BERNANKE. Bill, can you take that?

MR. DUDLEY. I think two things will happen. One, if things settle down and liquidity in the market improves, then we would stop adding more reserves than we think the market really needs. The excess liquidity we add today, though, will probably make it hard to push the funds rate up. Let's say that the funds rate falls out of bed today. We could see a sloppy funds rate for a couple of days because the two-week reserve maintenance period goes through Wednesday. Now, once you restart the reserve maintenance period next Thursday, the banks will have a whole new reserve regime, and I think at that time the sloppiness would be pretty much over. So we could definitely see a situation in which, if we're effective, the funds rate could be on the soft side, and that could last through Wednesday of next week. But after that, it will be a new reserve maintenance period, and I don't think we'll have any difficulty there.

CHAIRMAN BERNANKE. President Lockhart has a question. Dennis, why don't you come sit up here so everyone can see you?

MR. LOCKHART. I don't think seeing matters that much. I have a question for President Geithner. Are any European or Japanese institutions to our knowledge in serious trouble?

VICE CHAIRMAN GEITHNER. We don't have any direct information.

MR. LOCKHART. Are there analogs to Washington Mutual or Countrywide, for example?

VICE CHAIRMAN GEITHNER. Well, you've already seen one significant intervention by the German authorities last week to guarantee the liabilities of a relatively small institution with some mortgage exposure, and the liquidity pressures that the ECB responded to yesterday indicate that there are broader concerns about exposure to losses into those institutions because of their subprime exposure. You're just seeing that in commercial paper now, rather than elsewhere. So we have no indications from our supervisory counterparts that any major institution in Europe is facing

a significant solvency problem now, but that doesn't mean there isn't one. We just haven't heard that from them yet. I think there is a general sense that a lot of this subprime stuff ended up, as it has in the past, in institutions in Europe. So I assume that we have the risk that, as the tide recedes further, you will see more distress there. But, again, we have no indication from any of our counterparts yet that any major institutions face a significant funding or solvency issue.

CHAIRMAN BERNANKE. Are there any other questions? Okay. Thank you for your questions and comments. This is what we're going to do now. There are additional things that we might consider in the future if problems continue or worsen—for example, a swap line to provide more dollar liquidity to Europe; a reduction in the discount rate; and then if we decide that the macroeconomic conditions warrant it, a change in the federal funds rate. Those things would require FOMC approval. So obviously, should we get to the point at which we want to take additional steps, we will be in touch with you, and if you have any further comments or questions, please let us know. Is there anything else? President Plosser.

MR. PLOSSER. Thank you, Mr. Chairman. I just would ask that you read the statement one more time for us before we close.

CHAIRMAN BERNANKE. Certainly.

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money and credit markets. As always, the discount window is available as a source of funding."

So there is just one procedural point. Again, this is not something that we're contemplating, but one possible thing we could do would be to lower the discount rate, reduce the 100 basis point spread between the discount rate and the federal funds rate. It's not obvious that it is the right thing to do. There are probably some technical and logistical issues concerned with it. It's not obvious that it would be helpful. But I just want to put it on a list of things that we might consider and to remind you that the procedure for doing it would involve requests from your boards and then approval by the Board of Governors. So should we come to that point and we begin to discuss that particular option, we would need the Presidents to get the assent of their boards so that we could go ahead and take that action. Are there any other comments or questions? All right. Well, we will keep you well apprised, and I'm sure you will be following the markets on your own. So thank you very much and good morning.

END OF MEETING